

SITPRO

International Trade Guides

Financial

Letters of Credit An Introduction

Letters of Credit - An Introduction

This guide is an introduction to letters of credit (L/C) - also referred to by banks and other financial institutions as documentary credits. The guide tells you what a letter of credit is, the types of letter of credit available and the internationally agreed rules that govern their operation.

You should read this guide together with the guide **Letters Of Credit - Best Practice** and SITPRO's set of three **Letters of Credit Checklists and Guides** for Importers, Exporters and Export Sales Representatives. The checklist designed for importers is to be used by purchasing staff when applying to local banks for letters of credit. The one for exporters is intended primarily for use in export sales and shipping departments. The export sales representative's guide advises on credits and some of the other responsibilities assumed on overseas visits.

To ensure a letter of credit is workable, trouble-free and provides the security of payment for which the credit was requested in the first place, it is essential to take simple yet effective precautions at the start. Working through the checkpoints set out in the various sections of the guide will help reduce discrepancies and associated unplanned costs.

Successive surveys by SITPRO and others have shown that well in excess of fifty percent of documents presented by exporters to banks for payment under letters of credit are rejected on first presentation. This can cause expensive delays for both the exporter and the importer and may even result in a lesser payment or no payment at all. A great many of those rejections could be avoided if more care was taken to ensure that the documents called for in the credit are properly completed.

The SITPRO **Letters of Credit Checklists and Guides** are designed to minimise unnecessary costs and risk when trading on the basis of letters of credit. They are aligned with and based on interpretation of Uniform Customs & Practice for Documentary Credits (UCP), produced by the International Chamber of Commerce (ICC). The current revision, UCP 600, is available from ICC UK (www.iccuk.net).

Definition

In simple terms, a letter of credit is an undertaking by a bank to make a payment to a named Beneficiary within a specified time, against the presentation of documents which comply strictly with the terms of the letter of credit.

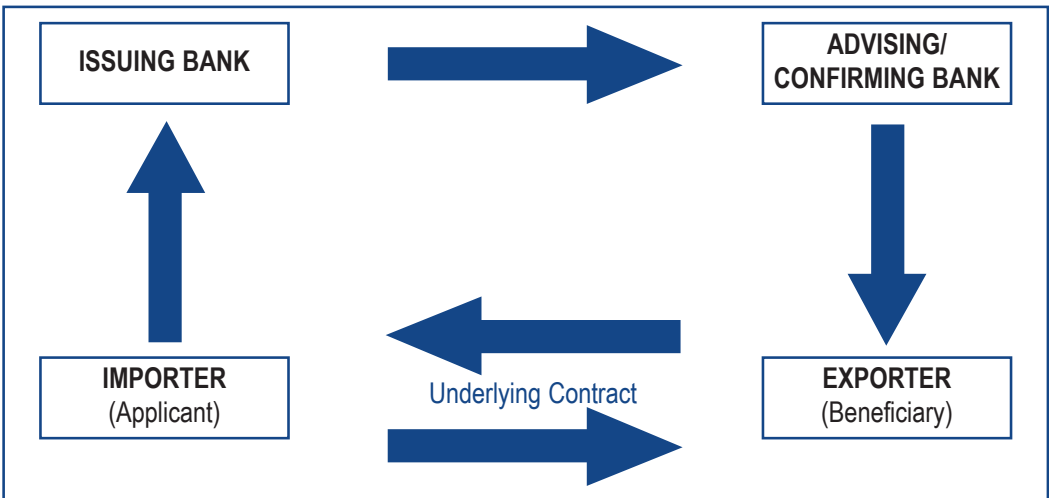
Its main advantage is providing security to both the exporter and the importer, but the security offered however, comes at a price and must be weighed against the additional costs resulting

from bank charges. The exporter must understand the conditional nature of the letter of credit and the fact that payment will not be made unless the terms of the credit are met precisely.

An importer/buyer (Applicant) may open a letter of credit if they wish to ensure that the exporter/seller (Beneficiary) has performed those requirements as per the underlying sales contract, by making the documentation requested conditions of the credit. (N.B. The sales contract is not an inherent part of the letter of credit, although the letter of credit may contain a reference to such contract).

When an exporter asks for payment by letter of credit, he is transferring the risk of non-payment by the buyer to the Issuing Bank -and the Confirming Bank if the letter of credit is confirmed-, providing the exporter presents the required documents in strict compliance with the credit, with the exception of cash in advance. For the exporter a letter of credit is the most secure method of payment in international trade provided the terms of the credit are met.

The following diagram shows those involved in a letter of credit transaction:



All parties in the letter of credit transaction deal with documents, not goods.

Should letter of credit be chosen as the payment method?

An importer should only be thinking of opening a letter of credit if his country's exchange control regulations require it or if the exporter insists upon it. Otherwise, the procedure ought to be avoided because it can quite often cause problems for both parties.

Exporters will need to be certain that it is necessary to use a letter of credit. Typical considerations include:

- Is it a legal requirement in the importing country?
- What is the country risk of the importing country
 - Would a confirmed letter of credit be more suitable?
- What is the usual practice in trading with that country and in that particular commodity?
- What is the value of the order?
 - Will the bank charges be out of proportion to the value?
- What is the importer's credit rating? Are they a new customer or has a trading relationship already been established?
- What is the standing of the Issuing bank?
 - Would a confirmed letter of credit be more suitable?
- Recommendation by banks who may advise that the best method of payment is a "confirmed irrevocable letter of credit" irrespective of the country, strength of issuing bank and without much regard to the value of the consignment
- Insistence by a Credit Insurer to trade on letter of credit terms with buyers in certain markets.
- Are there any other measures that could be taken to protect the exporter - e.g. credit insurance?
- Strategic decision made by the exporter - this strategy should be flexible to adapt to the changing risk profile of both the country and the buyer
- "Always traded this way"
 - The reasons for requesting this method of payment should be periodically re-assessed

Types of Letters of Credit

Irrevocable

- It can be neither amended nor cancelled without the agreement of all the parties to the credit
- The Issuing bank gives a binding undertaking to the Beneficiary provided all the credit terms and conditions are fulfilled
- Under UCP 600 all letters of credit are irrevocable

Unconfirmed

- A letter of credit forwarded by the Advising bank directly to the exporter without adding its own undertaking to make payment or accept responsibility for payment at a future date, but confirming its authenticity

Confirmed

- Where a bank usually in the Beneficiary's country, adds its own undertaking confirming that payment will be made as long as compliant documents are presented
 - This commitment holds even if the Issuing bank or the Applicant fails to make payment

- Confirmation gives the exporter added security, particularly if the standing of the Issuing bank is unknown or the current political and economic state of the importer's country is uncertain
 - Note: Banks may not wish to confirm letters of credit issued in certain countries
- A bank will make an additional charge for confirming a letter of credit
 - Confirmation costs will vary according to the country involved, but for many countries considered a high risk it will be between 2%-8%

Standby letter of credit

- A secondary payment mechanism used as support where an alternative, less secure, method of payment has been agreed
 - The parties involved with the transaction do not expect that the letter of credit will ever be drawn upon
 - They are also used in the United States of America in place of bank guarantees
- Often used to guarantee performance or to strengthen the credit-worthiness of a customer
- Should the exporter fail to receive payment from the importer he may claim under the standby letter of credit
- Certain documents are likely to be required to obtain payment including:
 - The standby letter of credit itself;
 - Sight draft for the amount due;
 - Copy of the unpaid invoice;
 - Proof of dispatch; and
 - A signed declaration from the Beneficiary stating that payment has not been received by the due date and therefore reimbursement is claimed by letter of credit
- The International Chamber of Commerce rules for operating standby letters of credit are UCP600 and ISP98 International Standby Practices

Revolving letter of credit

- Used for regular shipments of the same commodity between the same exporter and importer
- The credit must state that it is a revolving letter of credit
 - It may revolve either automatically or subject to certain provisions
- Avoids the need for repetitious arrangements for opening or amending letters of credit
- can revolve in relation to time or value
 - If the credit is time revolving once utilised it is re-instated for further regular shipments until the credit is fully drawn
 - If the credit revolves in relation to value once utilised and paid the value can be reinstated for further drawings

Transferable letter of credit

- The exporter has the right to request the paying or negotiating bank to make part (or all) of the credit value available to third parties
 - Useful for those acting as middlemen, especially where there is a need to finance purchases from third party suppliers
- At the request of the (first) Beneficiary, it may be made available in whole or in part to another (second) Beneficiary
 - A credit may be transferred in part to more than one second Beneficiary

Back to back letter of credit

- Can be used as an alternative to the transferable letter of credit
- A letter of credit is used as security to establish a second letter of credit issued by the Advising Bank in favour of the exporter's merchandise supplier –rather than transferring the original letter of credit to the supplier
- Many banks are reluctant to issue back to back letters of credit due to the level of risk to which they are exposed, whereas a transferable credit will not expose them to risk higher than that under the original credit

Uniform Customs and Practice for Documentary Credits (UCP)

Most letters of credit are subject to UCP: the universally recognised set of rules governing the use of the documentary credits in international trade. UCP was originally formulated in 1933 by the International Chamber of Commerce (ICC) and the current revision (UCP 600) came into effect on 1st July 2007. All definitions and general documentary requirements referred to in this briefing are in accordance with UCP 600 unless otherwise stated (it should be remembered that in some instances this may differ from national law). SITPRO would recommend using letters of credit that are subject to UCP 600. It is important to negotiate, as soon as possible, which party will bear the bank charges. It is worth remembering that on a small transaction these may be out of proportion and if these costs are not included in the pricing any profit may be completely eroded.



7th Floor
Kingsgate House
66-74 Victoria Street
London
SW1E 6SW

Telephone: +44 (0)20 7215 8150
Fax: +44 (0)20 7215 4242
Email: info@sitpro.org.uk
Website: www.sitpro.org.uk

SITPRO Ltd. is a company limited by guarantee
Registered in England & Wales No: 4188890

© Copyright SITPRO Ltd. 2007
This guide may not be republished, in full or in part, without SITPRO's prior permission

UCP600 contains the rules for the use of letters of credit. Where there are any inconsistencies with this guide, UCP600 will prevail.